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TREASURY FOR INTERNATIONAL AFFAIRS - J.ROSE
COMMERCE FOR 4121/ITA/IEP:S.MATHEWS, A.TAYLOR
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TAGS: EINV BEXP ECON ECIN OECD TU
SUBJECT: STABILITY VS. THE CANCER OF INFORMALITY

REF: PARIS 7395

NOT FOR INTERNET DISTRIBUTION CONTAINS REPORT OF OECD MEETING.

¶1. Summary: On November 6, at the Organization of Economic Cooperation and Development (OECD) Global Forum on Investment, an OECD Country Roundtable examined Turkey's recent experience with strategies to enhance the investment environment and the dramatic improvement in foreign investment in Turkey over the last five years. The main focus was on the impact of regulatory reform on Turkey's investment climate. The session began with a series of welcoming remarks, the highlight of which was a speech by Economics Minister Ali Babacan which was televised live by most major Turkish networks. The roundtable itself consisted of remarks by Karl Sauvant, Columbia School of Law; Andrew Vorkink, World Bank Country Director, Cavit Dagdas, Deputy Undersecretary of Treasury, and Ferit Sahenk, Chairman of Dogus Holding, followed by a short question and answer period. End Summary.

Stability, Stability, Stability

¶2. Economics Minister Ali Babacan repetedly stressed the need for both economic and poitical stability as the indispensable foundationfor all of the conditions needed for a positive nvestment climate. He attributed mch of Turke's progress over the last for year to a ruing pary with a strong parliametary majority able to implement stable and realistic macroeconomic policies. Babacan, who is also Turkey's chief EU accession negotiator, described the long-term future of Turkey as linked to full EU membership.

This vision has been a primary focus over the past four years and will be a defining force for the next five to fifteen years, he noted, describing the level of predictability provided by Turkey's EU anchor as the primary difference between Turkey and other emerging markets.

¶3. Turkey's economy has improved greatly over the last four years with greater than 7.5% annual growth paralleled by diminishing inflation for most of the period. Babacan explained that the Government of Turkey (GOT) had focused on bringing high, unpredictable inflation under control and on de-linking growth and inflation. Turkey missed its inflation target this year, but was focused on meeting its 4% target for 2007. He explained that the GOT recognized that tight monetary policy and budgetary discipline were vital to macroeconomic stability and noted that Turkey had achieved the first of the Maastricht Criteria (budget deficit under 3.5%.) Declining interest rates contribute to the reduction of the debt burden with debt to GDP ratios of 90% in 2000 falling to 55% in 2005 and 50% in 2006.

¶4. Babacan described several areas in which structural reforms had contributed to macroeconomic success. Banking sector reform undertaken with the support of the IMF has greatly improved the legal framework as well as regulation and put Turkey on the path to Basel II. Social Security remains a very serious problem, he acknowledged, with both legal reforms as well as a restructuring of the health insurance system yet to be completed. The GOT is working with the World Bank on reforms that would reduce unemployment. These reforms must parallel the EU accession process and should include both the education system and the manpower market. Tax reform is ongoing with corporate taxes recently reduced to 20%. Privatization has seen more reforms in the past 4 years than ever before he claimed. Finally the GOT is working to simplify regulations related to founding companies, reducing red tape and national treatment of joint venture companies that should make Turkey a more attractive location for foreign direct investors.

Quality, Competition, the Cancer of Informality and Other Roundtable Topics
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¶5. Sauvant made a general presentation on world FDI noting that over the next four years (2006-2010) annual flows should stabilize in the region of $1.2 - $1.4 trillion with inflows to emerging markets hovering in the range of $410 - $430 billion during the same period. This scenario has important implications for Turkey and other emerging markets in three areas: regulation and institutions, incentives and the nature of FDI. With FDI flows more or less stable in the near term regulatory competition is likely to compete. As FDI regimes become more similar quality will become increasingly important, particularly in the area of post-investment services and administration. More sub-national entities will offer incentives with the attendant possibility of "incentive wars." Governments must rationalize internal competition at the national level and focus on incentives that will add value ("quality incentives") not just to the foreign direct investor but also to local firms in the surrounding area, such as infrastructure improvements. Finally Sauvant stressed the need for emerging markets to attract quality FDI, in other words FDI that contributes to economic development such as tech intensive higher-value-added FDI in manufacturing and services.

¶6. Vorkink discussed steps to improve Turkey's investment climate, noting even if Turkey sustains FDI at $15 billion per year, Turkey will still be receiving less than 3% of GDP in FDI, less than key competitors and what is needed to sustain growth. He noted that privatization as well as mergers and acquisitions in the financial sector are not a sustainable source of FDI in the medium- to long-term and that competition for greenfield investment is key. Turkey must grow faster than EU countries to converge with EU income levels and will need to invest 8-10% of GDP to sustain that

level of growth, he argued. At the same Turkey needs FDI to finance its chronic current account deficit. There is room for improvement and the GOT is considering a program that would make many of the necessary reforms, he noted.

¶7. Vorkink described a broad challenge stemming from "the cancer of informality." Vorkink described a workforce with over half of all participants (53%) in the informal sector. This is damaging to both the formal sector, which is taxed to provide government services to the informal sector, as well as to the informal sector, which is consistently less productive because enterprises are small-sized, cannot benefit from economies of scale and lack access to financial markets. A large part of public sector expenditures are non-discretionary and produce low returns (debt serve, public sector wages, social security) making it difficult for the government to lower taxes. Vorkink argued the only way out of this vicious cycle is attract more FDI through fiscal reforms, improvements to the investment climate, labor market reform, increasing financial sector efficiency and competitiveness, as well as fostering innovation and improving technology absorption. Vorkink singled out educational reform as Turkey's single most important reform both for the EU and for attracting FDI.

¶8. Dagdas returned to the themes of stability and predictability as enunciated earlier by Minister Babacan. Noting that competition would increase within emerging markets he stressed the need for both economic and political predictability as well as an investor friendly legal structure. He cited the GOT's ongoing economic and structural reform program and noted that the GOT worked closely with the private sector, mainly industry groups and chambers of commerce to vet laws and regulations prior to their introduction. He expressed great interest in the OECD Policy Framework for Investment (PFI), the subject of the sessions immediately following the Turkey Country Roundtable. He noted that adherence to the PFI would involve a restructuring of how the GOT looks at the investment climate because the PFI incorporates infrastructure, public governance and responsible business conduct while the current GOT structural reform program does not.

¶9. Sahenk stressed the tremendous change in mindset that had occurred in Turkey as it chose to embrace globalization and "be a part of the world." Turkey has adopted two very challenging reform programs, he explained, linked to the EU accession process and a very difficult IMF program. These reforms have established regulatory bodies, made the Central Bank independent and implemented changes that affect the entire social structure. Meanwhile, the reduction of inflation and interest rates means that investors can focus on the real economy in a way that was not possible in the 90's. He noted that political and economic stability was vital but that Turkey still had a long way to go. Citing the automotive sector as an example, he explained that multinational companies now use Turkey as a manufacturing hub not just for the region but for the world. In 1980 Turkey's annual vehicle production capacity was approximate 50,000 vehicles. Today annual production capacity is 1, 260,000 vehicles. Turkey is a young, dynamic country with a "demographic gift" but it must educate youth and create jobs. If it succeeds, Turkey will be a regional economic power, Sahenk argued. Turkey is an export-oriented, industrial society with a rapidly developing information society, but the GOT needs to develop a 5 - 10 year strategic plan that focuses on the strengths that come from a young population and strong productive capabilities and identify potential export markets and attract high quality FDI.

Comment

¶10. Turkey has indeed made remarkable progress since the 2001 financial crisis. Attracting enough FDI to sustain growth remains a challenge. Over the next few years the massive post-crisis privatization campaign will wind down and the rapid pace of mergers and acquisitions in the financial

sector will cool off. In order to sustain annual FDI at the better than $15 billion figure cited by Vorkink in his presentation the GOT must look long and hard at the steps it needs to take to become globally competitive for high-quality, greenfield FDI. End Comment.

JONES